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SUBJECT: PROFILE OF ETHIOPIA'S DEBT SUSTAINABILITY

REF: ADDIS 2800

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SUMMARY

¶1. (SBU) Although the government of Ethiopia (GoE) has assumed only minimal new official external bilateral and multilateral debt since completing two rounds of external debt relief, state-owned enterprises (SOE) are accumulating off-budget external (and domestic) debt at an alarming rate. The GoE argues that SOE debt is not government debt and does not pose a liability to its already strained fiscal budget. The GoE has made a distinction between debts taken on by the state (reflected in the national budget) versus off-budget debt accrued by SOEs. The GoE maintains monopoly control over SOE operations and procurement activities and places high level government officials on SOE executive boards. The government has authorized SOEs to take on large amounts of debt from both domestic and foreign sources in order to fuel massive infrastructure development initiatives. The GoE has essentially transferred its historical appetite for external public debt financing onto the books of purportedly independent SOEs. The level of SOE debt and GoE fiscal exposure to such debt remains unclear.
END SUMMARY.

BACKGROUND

¶2. (SBU) Ethiopia reached the completion point under the Heavily Indebted Poor Country (HIPC) initiative in 2004 and Multilateral Debt Relief Initiative (MDRI) in 2006. Since the inception of debt relief, Ethiopia's current debt picture has demonstrated two divergent scenarios: 1) a rapid increase in off-budget debt taken on by SOEs, and 2) a steady decrease in on-budget external public debt loads. SOEs have been accumulating debt at a break-neck pace as the GoE has channeled state and private resources to SOE coffers in order to undertake massive national infrastructure development projects. The GoE has loosely regulated SOE borrowing, allowing its own Commercial bank to provide large loans and favorable financing terms to SOEs. As of September 2008, the total stock of outstanding SOE domestic debt reached USD 978 million, roughly five percent of GDP. The Ethiopian Electric Power Corporation owns the bulk of this domestic debt as a result of issuing coupon bonds to the Commercial Bank of Ethiopia. In addition, the GoE has encouraged external private and quasi-private financing from China and India to fund major SOE national infrastructure projects. The total stock and financing terms of these deals between SOEs and private foreign investors is unclear and GoE interlocutors have refused to claim them or disclose balances or terms with us. According to press accounts, post has inferred that the total stock of SOE accumulated external debt is in excess of USD 3 billion.

¶3. (SBU) On the other hand, Ethiopia's official external public debt load offers a different picture than the soaring SOE debt situation. Prior to debt relief initiatives, Ethiopia's stock of external public debt stood at USD 7.4 billion in 2003. After debt relief, according to official statistics, the stock of official external public debt declined from 39.6 percent of GDP in 2006 to USD 2.75 billion or 12 percent of GDP in July 2008. Of this, multilateral debt declined from 32.2 percent of GDP to 6.7 percent while official bilateral debt shrunk from 5.1 percent to 4.1 percent and commercial loans from 2.3 percent to 1.2 percent in the same period. The GoE has aggressively sought to decrease the stock of its on-budget

external public debt. The GoE has attempted to improve official budget transparency as it relates to gains from debt relief, by implementing a specific budget line item to show gains from debt relief. The IMF assesses that the current level of Ethiopia's external public debt has been sustainable as a result of disciplined fiscal programs and the rapid growth in export earnings in the last several years. However, there is now an increasing chorus of bilateral and multilateral donors who have publicly called for the GoE to rein in public sector spending and non-concessional SOE financing to support its aggressive infrastructure projects. A July 2008 IMF staff report advised the GoE to increasingly rely on concessional financing to avoid medium and long-term external debt distress.

SOE DEBT NOT A LIABILTY SAYS GOE

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¶4. (SBU) The GoE contends that SOE debt is not a liability. As a result, the GoE has maintained a public veneer of independence from SOE activities. The State Minister for Finance and Economic Development, Mekonnen Manyazoel told EmbOffs on September 22 that the day-to-day operations and private debts accrued by SOEs like Ethiopian Airlines, Ethiopian Telecommunications Corporation (ETC) and Ethiopian Electric Power Corporation (EEPCO) are subject to SOE shareholder and management review and do not pose a risk to the GoE. The GoE's rationale for allowing the rapid accumulation of debt in SOEs is embedded in the notion that SOEs operate independently and bear no liability to the state's already tight fiscal budget. Nevertheless, the GoE has courted private investors from China and India in order to provide debt financing for its SOE infrastructure projects. Additionally, the GoE still maintains monopoly control over its SOEs and sits several senior government Ministers or ruling party Executive Committee members on the executive boards of SOEs. All SOE private financing deals continue to be approved by GoE board members, which fall in line with government development targets. Over the past two years press reports have highlighted that the GoE signed a USD 640 million soft loan with India's EXIM bank to develop the domestic sugar sector. The GoE concurrently authorized ETC to sign a USD 2.4 billion vendor financing loan with China's ZTE Corporation to modernize and expand Ethiopia's telecom services.Q,lQq6QQQonstruct a 5,000 km railway network within the country in the next 8-10 years at an estimated cost of USD 5 billion. The GoE expects foreign contractors to finance 55 percent of this USD 5 billion project in hard currency loans and Ethiopia's banks to provide the remainder of the financing. While it is unlikely that these are the only such external loans to Ethiopian SOEs, we do not know whether the USD 3 billion (estimated) accumulated debt and the proposed USD 5 billion debt for railway network reflects all, the majority, or just a fraction of SOE's current and future debt burdens.

¶5. (SBU) Ethiopia's domestic public debt has soared due to heavy SOE borrowing from Commercial banks of Ethiopia. The government's push to upgrade the country's physical infrastructure through massive investment in SOE ventures has significantly drawn down domestic banking resources and strained the country's balance of payments. Public domestic debt is now roughly USD 6.0 billion, which is about 2.5 times the value of that of on-budget external public debt (External debt: USD 2.75 billion - SOE portion unknown). According to the National Bank of Ethiopia, SOEs account for about USD 978 million (roughly five percent of GDP) of the domestic public debt. In 2005/06, the stock of external and domestic public debts as a percentage of GDP were relatively even (Domestic debtJ_QRQ5Lby the World Bank,
heavy SOE borrowing
remains a significant risk to the GoE's debt sustainability. The fast growing stock of SOE debt obligations as indicated by the steady stream of publicized SOE financing deals in the local Ethiopian media has not been accurately calculated to date because of the lack of transparency in SOE budgets and the GoE's reluctance to publicly accept liability for SOE debt.

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DEBT SUSTAINABILTY MAY FAIL STRESS TEST

¶7. (SBU) Although the IMF has projected Ethiopia's stock of public external debt to be moderate, the large financing needs of SOEs, low expected FDI inflows, low elasticity of demand for Ethiopian exports and fuel inflation may precipitate a return to an unsustainable debt scenario. The Economist Intelligence Unit's (EIU) October 2008 report alsQ_QA]Qf8jects a sharp increase in
Ethiopia's debt-to-export ratio and a subsequent potential breach in its sustainable debt thresholds, primarily as a result of likely less favorable financing terms on future public and SOE debt. The IMF has privately admitted to EconOff that they simply have not had the facility or capacity to monitor levels of SOE borrowing and financing terms from external sources. Also, a dip in export growth may also push Ethiopia into an unsustainable debt scenario.

According to the DSA report, in order for the GoE to support this current debt sustainability assumption, Ethiopia must maintain a baseline GDP growth rate of seven percent over the next four years. The IMF projects that debt indicators will worsen if GDP growth drops to five percent per annum for the next five years. The global financial crisis, uncertain climatic conditions, and the low-demand elasticity for Ethiopian exports remain serious threats to double-digit output and export growth.

COMMENT

¶8. (SBU) To date, the GoE has not been able to quell significantly its large appetite for heavy domestic and external debt financing in its SOEs for its widespread physical infrastructure projects. Although it has exercised fiscal prudence in maintaining low levels of its official external debt loads since HIPC and MDRI debt relief in 2006, the government has essentially redirected most of its new debt obligations to SOEs. The GoE's contention that SOE debt is not a public liability seems to run contrary to the fact that the GoE controls these SOEs and their ultimate repayment will draw from the country's common pot of limited hard currency reserves. In addition, the GoE implicitly assumes the risk of SOE borrowing particularly since all major SOE capital expenditures and borrowing are approved by the GoE officials who sit on SOE boards. The GoE appears intent to convince itself and the international donor community that its strict fiscal tightening with respect to on-budget spending and external public debt maintenance is the true barometer for assessing its debt sustainability. It is clear, however, that the increasing value and volume of SOE debt cannot be reasonably separated from government liabilities, since the GoE in fact benefits from the growth and profitability of these same SOEs. Also, the GoE's reliance on sustained double digit output and export growth to reduce their debt burden hangs on tenuous climatic and global economic cycles. The tricky questions remain: how much longer and at what cost can the GoE support the growing SOE debt burden and rely on export-led growth to meet its fiscal commitments? END COMMENT.

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